Beneath the Surface

April 2024

SIGNET

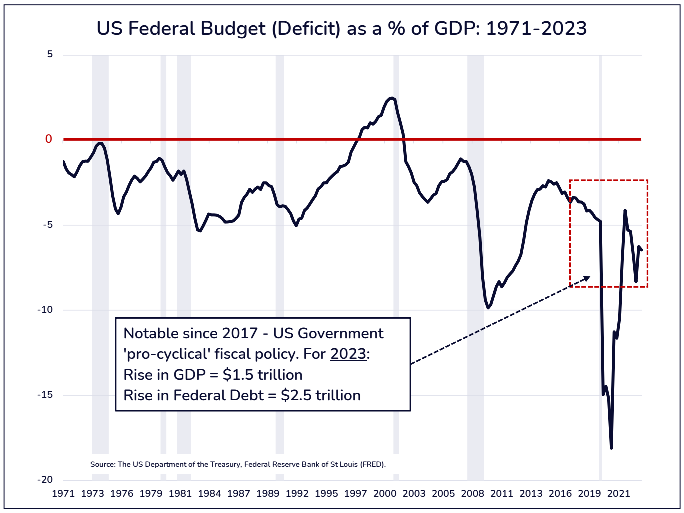
All is Great, Right?

- US economic growth and leading equity markets remain remarkably robust, despite the aggressive interest rate policies over the last two years, while economic growth outside the US remains lackluster at best. Why? This note identifies two high-level reasons. The chart, below left, shows the US federal budget deficit as a percentage of GDP and it suggests that fiscal policy may have recently 'crowded out' monetary policy. US fiscal policy has been procyclical since 2017 and on something of a 'war footing' since 2020. To put this into context, the US federal budget deficit-to-GDP ratio is currently 6.5% and it averaged 5.4% during the 2008-09 Great Financial Crisis (GFC).

- However, while robust lagging and coincidental economic data are great for the 'soft landing' debate, remember that monetary policy operates with long and variable lags. Also consider that with such aggressive and procyclical fiscal policy, net national savings is now negative in the US, and we have only occasionally witnessed that dynamic: during the Great Depression and during the GFC. A net national negative savings position should adversely impact investment (remember that S=I), productivity and economic growth. A deficit-funded government fiscal multiplier may be positive for an economy in the short run, but there is evidence to suggest that it becomes ineffective, or even negative, in highly-indebted economies over the longer term. This is largely because it crowds out productive private investment and this should ultimately be reflected in higher equity risk premia, which we are not currently seeing.

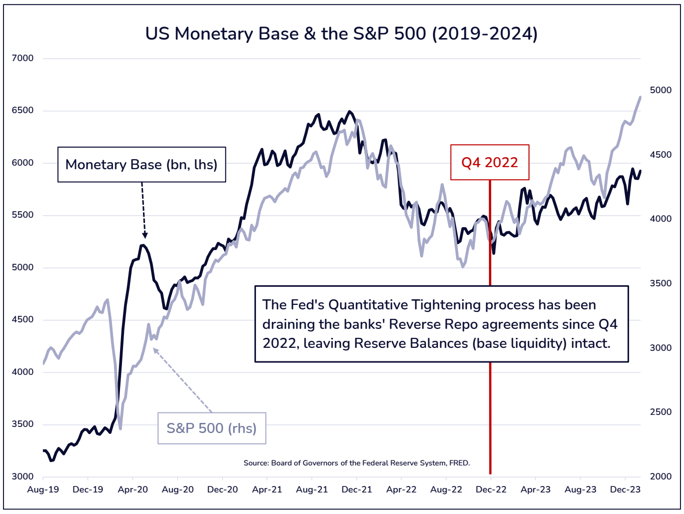
- The chart, below right, highlights base liquidity in the US (USD) against the S&P 500. Contrary to the conventional perception of quantitative tightening (QT), liquidity and financial conditions have been accommodative since Q1 2023, around the time some UK, US and Swiss financial intermediaries began experiencing stressed circumstances. The abundant central bank liquidity has indirectly supported market prices and confidence. The US monetary base, viewed from the commercial banks' 'Reserve Balances' perspective – their liquidity cover – has been maintained because the QT programme of draining excess liquidity ($95 billion a month) has been taken from the Fed's Reverse Repo Facility. This relatively new facility had been used extensively from 2021-2022 to absorb the excess liquidity, but it has recently declined from a peak of $2.4 trillion in January 2023 to $0.4 trillion now. This excess liquidity is diminishing rapidly of course, much like household excess savings, and we might therefore expect to see QT suspended before interest rates really start to bite. Without a suspension, and with the ongoing net new Treasury debt issuance, commercial banks will be forced to draw down their reserves, reduce or tighten lending standards, reduce leverage or sell assets. In each case, the repercussions for the markets and the economy are less than rosy.

- So, perhaps all is not so great. The downward trend in inflation now gives central bankers an easy option to cut rates later this year, or as a reaction to sudden market or economic weakness. Despite this, and despite the US fiscal and monetary splurge described above, we continue to urge qualified caution. We can highlight investments that may become attractive if economic conditions take a turn for the worst. Please contact us for details.


US Federal Budget (Deficit) as a % of GDP: 1971-2023

Notable since 2017 - US Government 'pro-cyclical' fiscal policy. For 2023:
Rise in GDP = $1.5 trillion
Rise in Federal Debt = $2.5 trillion

Source: The US Department of the Treasury, Federal Reserve Bank of St Louis (FRED).


US Monetary Base & the S&P 500 (2019-2024)

The Fed's Quantitative Tightening process has been draining the banks' Reverse Repo agreements since Q4 2022, leaving Reserve Balances (base liquidity) intact.

Source: Board of Governors of the Federal Reserve System, FRED.

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